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November 18, 2008

Midwestern Greenhouse Gas Reduction Accord Advisory Group
c/o Mr. Jesse Heier
Washington Director
Midwestern Governors Conference
Council of State Governments
444 North Capitol Street, N.W.
Suite 401
Washington, D.C. 20001

Dear Advisory Group Members:

The American Forest & Paper Association (AF&PA) appreciates the opportunity to submit comments to the Midwestern Greenhouse Gas Reduction Accord (MGA) Advisory Group as it prepares to finalize its Preliminary Recommendations (released November 1, 2008). We also appreciated the opportunity to attend and speak at the MGA meeting held in Washington, D.C. on October 20 and 21.

AF&PA is the national trade association of the forest products industry, representing forest landowners and pulp, paper, paperboard and wood products manufacturers. The U.S. forest products industry accounts for approximately six percent of the total U.S. manufacturing GDP, placing it roughly on par with the automotive and plastics industries. The forest products industry generates over $200 billion a year in sales and employs more than one million people earning $54 billion in annual payroll. The industry is among the top ten manufacturing sector employers in 48 states. In the states participating in the Midwestern GHG Reduction Accord, the forest products industry employs approximately 190,000 people with an estimated annual payroll exceeding $10 billion.[1]

The implementation of a cap and trade system for reducing greenhouse gas (GHG) emissions will have a significant impact on the forest products industry operating in the region. The following comments highlight some of the key design elements that are critical to our remaining an economically viable industry going forward. We have also attached our more detailed comments that we submitted for your consideration in July.

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[1] Does not include Manitoba or observers

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Greenhouse Gas Profile

The forest products industry's carbon footprint is unique. A significant portion of our energy needs are met through the use of carbon neutral biomass; however, we also use significant amounts of fossil fuel. The pulp and paper portion of the industry is particularly energy intensive with energy costs (nationally) averaging upwards of 13% of total costs. We also sequester carbon in our forests and the many products we produce. Paper recycling reuses a renewable resource that sequesters carbon and reduces greenhouse gases by avoiding methane emissions from landfills, as well as reduces the energy required to produce a number of paper products.

Between 2000 and 2006, AF&PA members reduced their GHG emissions intensity by 14 percent. If direct and indirect emissions are totaled, there has been a decrease in absolute emissions of 24.6 percent, falling from 88.0 million metric tons of carbon dioxide (CO_2) equivalents to 66.3 million metric tons. Approximately half of this reduction can be attributed to improvements in GHG emissions reductions, such as efficiency improvements or reduced fossil fuel use, and half can be attributed to decreases in production and changes in baseline from the year 2000.[2] Production of pulp and paper products in the United States is declining, and reductions in GHG emissions reflect this trend.

Competitiveness Concerns

The forest products industry faces increasing domestic and international challenges– particularly increasing energy costs and global competition. U.S. imports of forest products have grown during this decade, for the most part, at a faster rate than exports, resulting in wide trade deficit in the sector. Imports from countries that do not have GHG reduction obligations are increasing. For example, U.S. imports of paper, paperboard and converted products from China jumped by more than 430% between 1998 and 2007 and stood at $2.1 billion last year. Chinese imports now represent 12% of total U.S. paper product imports, up from 3% in 1998. Moreover, the rapid growth of the Chinese paper industry -- and to a lesser extent the paper industry in several other advanced developing countries -- suggests that this trend will continue, and possibly accelerate, in the future. Government financial support for new manufacturing capacity has been a key component of the growth of the paper sector in China and a number of other developing countries. In contrast, U.S. paper industry manufacturing capacity has been declining.

Considering the long-term trends in the industry's competitiveness, imposing climate change regulation on U.S. manufacturing without requiring equal actions from other high-emitting countries will further weaken U.S. manufacturing competitiveness.

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[2] http://www.afandpa.org/Content/NavigationMenu/Environment_and_Recycling/Environment,_Health_and_Safety/Reports/AF&PA_EHSReport08_final5web.pdf

Similarly, imposing regional climate change regulation in the absence of a global program will weaken the competitiveness of manufacturing in the Midwestern region.

The financial performance of the U.S. forest products industry has been sub par during the current decade as a result of rising costs and competition. The industry earned a 4.5 percent rate of return on capital from 2000 through 2007, which was about half (55 percent) the rate for total U.S. manufacturing. The industry's profit margins, measured as a percentage of sales, averaged just 3.7 percent during that same period, as compared with profit margins of over 8 percent for all U.S. manufacturing.

Since early 1997, more than 145 pulp and paper mills have closed in the U.S., contributing to a loss of 86,000 jobs, or 40 percent of our workforce. An additional 80,000 jobs have been lost in the wood products industry since 1997. Many of these jobs were in rural areas and were the major source of employment for the locale. Increasing energy costs and the recent downturn in the nation's economy, especially the housing market, have only compounded these challenges.

AF&PA believes the best U.S. climate change policy option for addressing competitiveness concerns is to make the program costs as low as possible for U.S. industry. This means designing economy wide programs where appropriate, allocating (versus auctioning) allowances to all sectors covered under the cap and trade program, instituting flexible offset policies without significant restraints, and timing emissions cap reductions with the availability of new energy efficient technology.

Allowances

Allocating allowances proportional to historical emissions is essential for maintaining a viable forest products industry in the U.S. The forest products industry has limited ability to pass along increased costs to its customers due to increasing foreign competition. Therefore, the industry will have to absorb the cost of reductions, as well as those of the electric power and petroleum distribution sectors that are passed on in the form of increased electricity and fuel prices. Without an adequate allocation of long-term allowances, the U.S. forest products industry would see its slim profit margins significantly reduced or eliminated.

For example, in the pulp and paper portion of our business (the portion of the industry with the majority of emissions), our members' annual profits averaged about $4.3 billion per year from 2000-2007. Meanwhile, in 2006, members' pulp and paper facilities emissions were 61.5 million metric tons carbon dioxide equivalents. At an allowance price of $30, purchasing allowances at auction would cost pulp and paper manufacturers nearly two billion dollars or almost half of their profits. At $50 per ton, approximately three-fourths of the pulp and paper sectors' profits would be eliminated. No manufacturer of low margin commodities in an international marketplace could sustain this impact. It is likely that many facilities would shut down, and production (and jobs) would shift to other (unregulated) regions of the U.S. or foreign countries. It is important to note that profit levels will be much lower than stated above for the foreseeable future due to the recent economic downturn.

Cap and trade programs can provide relative economic benefit in that, when reasonably implemented, they can drive towards the goal of the lowest achievable compliance cost. Auctioning allocations, however, turns the system into a tax. Auctions should be minimized or eliminated.

In addition to auctions, AF&PA is against the use of energy efficiency benchmarks as the basis for allocating emissions allowances. First, performance benchmarks defeat the intended purpose of a cap and trade policy, which is to allow the emissions reductions to take place at the lowest cost source. Second, facilities have different ages, sizes, and technologies -- it would not be fair to punish older or smaller facilities, which generally are less efficient. In addition, forest and paper products are produced from a variety of fiber blends and by different manufacturing processes which makes comparisons among different manufacturing facilities difficult to make. For example, the Netherlands spent four years developing pulp and paper industry benchmarks. Sixty-eight benchmarks originally were identified for the pulp and paper industry; even so, no stakeholders felt their facilities were accurately characterized. In short, an overly complex and subjective allocation method is unnecessary, particularly when the resulting allocation to industry sectors and facilities may not be significantly different from allocation based on historical levels. Finally, the increasing cost of energy historically has driven significant energy efficiency improvements and will continue to do so in the future.

Finally, the program give credit for early, verifiable reductions, including reductions made under voluntary programs such as the Climate Vision Program, Climate Leaders, Chicago Climate Exchange or via individual company commitments. Credit for early action should come from an allocation outside the cap and be limited to a ten year look back period from the start date of the program. We recommend that MGA propose some criteria that could be used to determine a maximum “early action” look back baseline, the adoption of which would ensure some degree of consistency and integrity to the process.

Offsets

Allowing use of offsets to mitigate emissions regulated by a cap and trade program is an important component for limiting costs of the program. Increasing the availability of credits in the market through offsets will help keep compliance costs lower than they would otherwise be. There should be broad flexibility in allowing real, verifiable offset credits that a company can generate and utilize to mitigate its GHG emissions. There should be minimal or no limits on the number or location of offsets allowed by the policy.

Carbon stored in managed forests and forest products should be eligible for offset credits. Recycling activities should also be recognized as eligible carbon offset project types. Greenhouse gas reductions result from avoided methane emissions and reduced energy required to produce a number of paper products. AF&PA looks forward to working with the MGA in the future on developing appropriate forestry and recycling protocols.

AF&PA is currently participating in a broad stakeholder effort with U.S. and Canadian forestry and environmental groups to develop North American consensus forest carbon measurement standards. The goal of these new consensus standards, developed under a process accredited by the American National Standards Institute (ANSI), is to bring together existing and emerging forest carbon measurement protocols from state, provincial, regional, and national climate policies and programs. The resulting bi-national consensus standards will establish uniform policies across North America to provide a broadly-supported basis for forest carbon protocols in both countries.

It is imperative that carbon sequestration in managed forests and forest products be eligible as voluntary offsets. Over time, sustainable forest resources store additional carbon. Much of this sequestered atmospheric carbon is transferred into long-lived forest products. The climate benefits of this process are significant. In the U.S., carbon sequestered by forests and products each year is enough to offset approximately 10 percent of U.S. carbon dioxide emissions.[3] Forests and forest products also help offset fossil fuel emissions through the use of biomass energy and the low manufacturing energy requirements of wood products.[4] More than half the forestland in the United States is privately owned - roughly 424 million acres. Of that, 354 million acres are actively managed for timber. Private landowners in the U.S. plant an average of four million trees each day.[5] In the states participating in MGA, there are over 60 million acres of forestland, of which 37 million acres are privately owned.[6]

As stated in the Intergovernmental Panel on Climate Change Fourth Assessment (IPCC) Report, *Mitigation:*

> "In the long term, a sustainable forest management strategy aimed at maintaining or increasing forest carbon stocks, while producing an annual sustained yield of timber, fiber or energy from the forest, will generate the largest sustained mitigation benefit."[7]

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[3] The State of America's Forests SAF 2007 (http://www.safnet.org/aboutforestry/StateOfAmericasForests.pdf)
[4] Framing a home with wood instead of steel or concrete can save 26% to 31% greenhouse gas emissions over the life of the home (www.corrim.org)
[5] [1] Forest Resources of the United States, 2007; Draft RPA Review Tables: U.S. Dept. of Agriculture, http://www.fia.fs.fed.us/documents/pdfs/2007_RPA_REVIEW_TABLESv2c.pdf;
Tree planting in the United States - 1999; U.S. Dept. of Agriculture
[6] Does not include Manitoba or observers
[7] (Source: IPCC. 2007. *Mitigation, Fourth Assessment Report*)

Timing of Reductions with Availability of Technology

Timing emissions cap reductions with the availability of new energy efficient technologies is critical. The development and implementation of new technology is essential to achieving the ambitious goals outlined in current legislative proposals. The timing of the decline in caps should take this into account to avoid unnecessary short-term escalations in energy costs that could force companies out of business before new technology can come online. It is important to note that there are no end-of-pipe controls for CO_2, and most reductions will need to come from energy efficiency improvements and fuel switching to lower carbon energy sources. For the forest products industry, much of the "low hanging fruit" has been picked in terms of energy efficiency improvements, and large capital investments will be required to make further significant gains.

Carbon Neutral Biomass

AF&PA would like the MGA to affirm that CO_2 emissions from the combustion of biomass are considered carbon neutral and are not regulated by the MGA program.

Nationwide, biomass comprises approximately 64 percent of the fuel used by AF&PA members' pulp and paper mills and 74 percent of the fuel used by wood products mills. The Intergovernmental Panel on Climate Change, the U.S. Environmental Protection Agency, the European Commission, and other internationally recognized climate policy groups have concluded that the combustion of biomass causes no net addition of CO_2 to the atmosphere. As a result, the emissions of CO_2 associated with the combustion of biomass are not included in greenhouse gas emissions totals. Reliance on biomass-based fuels is a key component of the U.S. national strategy to combat climate change.

Reporting

AF&PA is in favor of one national reporting system. The MGA should use the forthcoming EPA mandatory reporting protocol in order to avoid multiple reporting requirements for covered entities. In addition, special care should be given to maintaining confidentiality of certain reported data and keeping the administrative costs of reporting low.

Third party verification should not be required under the MGA. Reporting under mandatory programs, like that practiced under traditional environmental regulation, is subject to government review and enforcement and does not require (expensive) third party audits. Companies should be allowed to attest to the veracity of their data as they do in other state and federal environmental programs and be subject to state authorized audits of such information. U.S. manufacturers have a long history of providing truthful emissions and other environmental data to regulatory authorities under penalty of law. This approach is effective, has a proven record, and should be applied to this situation, as well. The need for third party verification should be market-driven, not mandated by government.

Scope

Generally speaking, we believe the more sectors under the cap, the more robust the market and the lower the cost of meeting reduction targets. However, some sectors of the economy may be better addressed through complementary measures outside of the cap, such as fuel economy standards or building code standards.

"Upstream" approaches offer the ability to cover transportation, commercial and residential sources because the cost of allowances is reflected in the prices of fuels, which in turn provides an incentive for those sources to reduce emissions by reducing fuel consumption (e.g., by buying more fuel efficient cars or heating equipment and by driving less or maintaining lower house temperatures in the winter). However, when such sources are regulated upstream under a cap and trade system, as is being considered in the MGA, it is essential that the overall cap be suitably adjusted to reflect the added demand for allowances. As part of determining the size of the cap increase, it is critical to consider the limited reduction opportunities that such sources may have, in large part because demand is relatively inelastic for fuels used in transportation and in residential and commercial settings. If those factors are not considered, then adding those sources to the cap and trade system becomes simply a back-door way of imposing more stringent obligations on larger sources by raising allowance prices, which AF&PA would oppose. In that event, those types of sources should be addressed by other means than the cap and trade program.

Although the jurisdictions involved in the MGA represent sizeable GHG emissions, national programs and international agreements are more effective approaches for addressing climate change. The development of multiple regional cap and trade programs ultimately diminishes the intended efficiencies of a cap and trade policy model. AF&PA supports a single national program and recommends that the MGA (and other regional initiatives) work toward a single program or, at a minimum, plan to fold the MGA into a federal program once it is established.

Unintended Consequences of Taking "Business as Usual" for Granted

In 2006, AF&PA member pulp and paper mills generated 64 percent of the energy they used from biomass; members' wood products facilities generated 74 percent of their energy from biomass. Currently, our industry is a leader in the use of energy efficient combined heat and power (CHP) systems (29 percent of all U.S. co-generated electricity is produced by pulp and paper mills). The carbon that U.S. forests and forest products currently store each year is enough to offset approximately 10 percent of all U.S. CO_2 emissions. More than half the forestland in the U.S. is privately owned--roughly 424 million acres. Of that, 354 million acres are actively managed for timber. Private landowners in the U.S. plant about 4 million trees each day.[8] EPA estimates

[8] [1] Forest Resources of the United States, 2007; Draft RPA Review Tables: U.S. Dept. of Agriculture, http://www.fia.fs.fed.us/documents/pdfs/2007_RPA_REVIEW_TABLESv2c.pdf; Tree planting in the United States - 1999; U.S. Dept. of Agriculture

that the amount of carbon stored annually in forest products in the U.S. is equivalent to removing more than 100 million tons of CO_2 from the atmosphere every year. In 2006, AF&PA member companies avoided 21.1 million metric tons CO_2e of methane through their use of recovered fiber that would have otherwise decayed in a landfill.

Since many forest products industry practices reduce greenhouse gases, it is important that policymakers create incentives for maintaining existing climate friendly practices. As climate policies often focus on incentivizing additional energy efficiency improvements, use of renewable fuels, or carbon sequestration in forests, they often fail to recognize the benefits of existing business practices that avoid GHG emissions and sequester and store carbon. In effect, this creates disincentives for existing users of renewable energy and owners of forests, distorts markets, and disadvantages those landowners and forest products manufacturers who are leaders now in the use of energy efficient combined heat and power, carbon neutral biomass, and forest and product sequestration. Unintended consequences occur when policies reward new entrants and disadvantage those that are currently engaged in the desired activity. Disincentivizing the maintenance of current carbon stock levels and avoided emission levels will undoubtedly lead to an increase in GHGs in the atmosphere.

In addition, credit for reduced indirect emissions and avoided emissions should be granted to the entity responsible for the reduction. For example, a facility that invests in combined heat and power that results in a decrease in purchased power should receive credit for that reduction (rather than the electric generator getting the credit). Similarly, “decoupling” policies designed to reduce emissions from utilities often have the perverse effect of disincentivizing energy efficiency improvements by customers (that result in the need to purchase less electricity). Utilities are often guaranteed a rate of return and make up the lost revenues from the decrease in volume of electricity sales by charging higher rates to customers. When this happens, customers do not realize the return on their investment in the energy efficiency project.

In Closing

Again, we appreciate the opportunity to comment on the design of the Midwestern Greenhouse Gas Reduction Accord. Please do not hesitate to contact us if you have any questions or if we can be of assistance in any way.

Sincerely,

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